

People's Republic of China

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China continues to enact new laws and issue regulations, orders, rules, and explanatory circulars that impact foreign investors. The continuing legal reform in China adds to the unpredictability of operating in the People's Republic of China (PRC). The best protection is to monitor the legal and political environments in order to benefit from these new laws and regulations. This article briefly summarizes the key legislation adopted by China in 1999, including a review of laws and regulations concerning contracts, securities, and mergers and acquisitions.

I. Uniform Contract Law

China's laws and regulations governing contractual relations, as developed over the past twenty years, have been overlapping and redundant in their application. A particular law was applied, based not so much on the type of contract involved, but rather on the citizenship of the parties to the contract (i.e., Chinese citizens versus foreigners). Although Chinese contract law in the late 1990s has evolved from a more paternalistic approach—registration and approval of contracts—to the recognition of freedom of contracts allowing parties to enter into commercial relationships, the Chinese government, however, still maintains that certain contractual relations with foreign parties require close supervision. The key laws governing commercial contracts include the Civil Law,¹ the Secured Interests Law,² and the Uniform Contract Law,³ which were adopted in March 1999 and supersede

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1. General Principles of Civil Law of the People's Republic of China, [Business Regulation] China L. Foreign Bus. (CCH) ¶ 19-150 (Apr. 12, 1986) [hereinafter Civil Law].

2. Secured Interests Law of the People's Republic of China, [Business Regulation] China L. Foreign Bus. (CCH) ¶ 5-605 (June 30, 1995) [hereinafter Secured Interests Law]; see generally *Creating & Enforcing Security in the PRC*, ASIA L. & PRAC. (1997).

3. Uniform Contract Law, [Business Regulation] China L. Foreign Bus. (CCH) ¶ 5-650 (Mar. 15, 1999); see *China Amends Draft Contract Law*, Dec. 24, 1998, ASIA PULSE, available in LEXIS, News Library; *Experts Discussing Contract Law*, Feb. 4, 1999, CHINA DAILY, available at <http://www.chinadaily.net/cndy>; Harpole,

the Economic Contract Law,⁴ the Foreign Economic Contract Law,⁵ the Technology Contract Law,⁶ and the Technology Import Contract Regulations.⁷

While the Uniform Contract Law expressly repeals the Economic Contract Law, the Foreign Economic Contract Law, and the Technology Contract Law, there is less certainty as to whether the law applies retroactively to contracts that were entered into pursuant to the laws existing at the time the contract was entered into.

The Uniform Contract Law addresses general contractual principles such as formation, validity of contract, performance, modification, assignment, termination, and liability for breach. The Uniform Contract Law provides that a contract "is an agreement among individuals, legal persons and/or other organizations as equal parties for the establishment,

Proposed New Contract Law, Dec. 1998, CHINA LAW; Josh Karlen, *New Contract Law Nearer in China*, NAT'L L.J. A14 (Sept. 7, 1998); *Parliamentary Chairman Studies Contract Law Legislation*, Jan. 13, 1999, XINHUA NEWS AGENCY, available in LEXIS, News Library; Hugh T. Scogin & Brett D. Braude, *New Contract Basics*, CHINA BUS. REV. 36 (Jan./Feb. 1999) (describing the September 1998 draft of the Uniform Contract Law). See generally Roderick W. MacNeil, *Contract in China: Law, Practice, and Dispute Resolution*, 38 STAN. L. REV. 303 (1986); Jiang Ping, *Drafting the Uniform Contract Law in China*, 10 COLUM. J. ASIAN L. 245 (1996) (discussing the distinctions between the Economic Contract Law and the Foreign Economic Contract (FEC) Law and the need for uniformity); Daniel Rubenstein, *Legal and Institutional Uncertainties in the Domestic Contract Law of the People's Republic of China*, 42 MCGILL L.J. 495 (1997); Yuqing Zhang & James S. McLean, *China's Foreign Economic Contract Law: Its Significance and Analysis*, 8 NW. J. INT'L L. & BUS. 120 (1987) (analyzing the FEC law). The Law Committee of the NPC requested and received the assistance and input from the public concerning the preparation of the Uniform Contract Law. In addition to various Chinese law professors and organizations, the Legal Committee for the American Chamber of Commerce in the People's Republic of China, Beijing, provided substantive feedback that the NPC accepted in preparing revised drafts. The author has communications and memoranda in his files concerning the efforts of the AmCham Legal Committee to participate in China's legislation drafting process. Article 428 of the Uniform Contract Law provides that the Economic Contract Law, the FEC Law, and the Technology Contract Law are repealed effective October 1, 1999.

4. Economic Contract Law of the People's Republic of China, [Business Regulation] China L. Foreign Bus. (CCH) ¶ 5-500 (Dec. 13, 1981) [hereinafter Economic Contract Law].

5. Foreign Economic Contract Law of the People's Republic of China, [Business Regulation] China L. Foreign Bus. (CCH) ¶ 5-550 (Mar. 21, 1985) [hereinafter FEC Law]. In 1984, the Guangdong Provincial Government developed a similar law for the Shenzhen SEZ. See Regulations of Shenzhen Special Economic Zone on Economic Contracts Involving Foreigners, [Special Zones & Cities] China L. Foreign Bus. (CCH) ¶ 73-505 (Feb. 7, 1984) [hereinafter Shenzhen FEC Law]. The Shenzhen FEC Law differs in some respects from the FEC Law and, in particular, with respect to the limitations period for contract actions. *Id.* art. 38. See generally Gary J. Dernelle, *Direct Foreign Investment and Contractual Relations in the People's Republic of China*, 6 DEPAUL L.J. 331 (1994); Roy F. Grow, *Resolving Commercial Disputes in China: Foreign Firms and the Role of Contract Law*, 14 NW. J. INT'L L. & BUS. 161 (1993); Mark C. Lewis, *Contract Law in the People's Republic of China—Rule or Tool? Can the PRC's Foreign Economic Contract Law Be Administered According to the Rule of Law?*, 30 VAND. J. TRANSN'L L. 495 (1997).

6. Law of the People's Republic of China on Technology Contracts, [Business Regulation] China L. Foreign Bus. (CCH) ¶ 5-577 (June 23, 1987) [hereinafter Technology Contract Law]; see also Administrative Measures of Beijing Municipality on Authentication and Registration of Technology Contracts, [Business Regulation] China L. Foreign Bus. (CCH) ¶ 5-579 (Dec. 1, 1990).

7. Regulations on Administration of Technology Import Contracts of the People's Republic of China, [Business Regulation] China L. Foreign Bus. (CCH) ¶ 5-570 (May 24, 1985) [hereinafter Technology Import Contract Regulations], available at <http://www.moftec.gov.cn>; see Detailed Rules for the Implementation of the Administrative Regulations of the People's Republic of China on Technology Import Contracts, [Business Regulation] China L. Foreign Bus. (CCH) ¶ 5-573 (Dec. 30, 1987) [hereinafter Technology Import Contract Detailed Rules]; see also Provisional Regulations of Shenzhen Special Economic Zone Governing the Import of Technology, [Special Zones & Cities] China L. Foreign Bus. (CCH) ¶ 73-510 (Feb. 8, 1984).

modification or termination of a relationship.”⁸ The law recognizes that the mutual assent of the parties is fundamental in contract formation and that the parties observe the principles of fairness, honesty, and good faith.⁹ The Uniform Contract Law further provides that “in forming and performing a contract, the parties shall follow the laws and administrative regulations and respect social public morals, and shall not disturb social and economic order or damage social and public interests.”¹⁰ A contract formed under the law shall be legally binding on the parties, each of which must perform its own obligations as agreed upon in the contract, and no party shall unilaterally alter or rescind the contract.¹¹

A. CONTRACT FORMATION

The Uniform Contract Law recognizes oral contracts on the condition they are performed immediately.¹² Otherwise, all contracts must be “in writing,” which can include “a written contract, letter, electronic data text (including telegram, telex, facsimile, electronic data interchange and electronic mail), etc., that can tangibly express the content contained therein.”¹³ The Economic Contract Law required that contracts contain certain mandatory language.¹⁴ In contrast, the Uniform Contract Law provides that a contract “shall generally include” the following terms and conditions:

- (1) name and domicile of each party;
- (2) subject matter;
- (3) quantity;
- (4) quality;
- (5) price or remuneration;
- (6) term for performance;
- (7) place and method of performance;
- (8) liability for breach of contract; and
- (9) dispute resolution procedures.¹⁵

8. Uniform Contract Law, art. 2. The Uniform Contract Law specifically does not apply to agreements concerning personal relationships such as marriage, adoption, and guardianship. See Civil Law, arts. 16–19 (describing guardianship rules).

9. Uniform Contract Law, arts. 3–6, 13, 60, and 92. The Uniform Contract Law holds the parties to a standard of good faith and fair dealing during contract negotiations. Specifically, a party is liable for damages if the other party sustains losses as a result of bad faith and dishonesty during contract negotiations. In addition, the law provides that a party to contract negotiations shall not reveal commercial secrets to third persons or misuse secrets that are disclosed during contract negotiations. If a party reveals or misuses another party's commercial secrets and the owner of such secrets sustains losses as a result thereof, the party in violation is liable for damages. *Id.* art. 43.

10. *Id.* art. 7.

11. *Id.* art. 8.

12. *Id.* art. 10. The recognition of oral contracts is a major change of policy from the rules under the Economic Contract Law and the Foreign Economic Contract Law, which require that all contracts be in writing. See Economic Contract Law, art. 7; FEC Law, art. 7. In earlier drafts of the Uniform Contract Law, the drafters required that “foreign-related” contracts be in writing. After receiving input from the foreign legal community in Beijing, the drafters deleted the requirement that foreign-related contracts be in writing.

13. Uniform Contract Law, art. 11. If a contract is concluded by the parties in the form of a letter or electronic data text, one party may, prior to the formation of the contract, require entry into a written confirmation. *Id.* art. 32.

14. Economic Contract Law, art. 12.

15. Uniform Contract Law, art. 12.

The law further provides that the parties "may refer to model texts of various contracts" in the preparation of a contract. The Uniform Contract Law, however, does not make reference to any particular "model" contracts that are either preferred or approved under Chinese law. Further, the law provides no guidance on how the courts or arbitration tribunals will treat the use of model contracts, especially if a "model" contract is untested in practice.¹⁶

In the absence of contract provisions addressing quality, compensation, and place of performance, the parties may enter into a supplemental agreement.¹⁷ For any terms that remain ambiguous, the Uniform Contract Law outlines the following rules of interpretation:

- (1) *Quality and Quantity.* In the event that the requirement of quality and quantity requested is ambiguous, the performance shall be made in accordance with national standards. In the event a national standard does not exist, the performance shall be made in accordance with customary standard.
- (2) *Pricing Terms.* In the event that the price is ambiguous, the payment shall be made in accordance with the market price in the place of performance at the time when the contract is executed. In the event that the price is fixed by the government pursuant to the law, the payment shall be made according to the price fixed by the government.¹⁸
- (3) *Place of Performance.* In the event the place of performance is ambiguous, the performance shall be made at the location of the recipient of the currency if a currency is to be delivered, or at the location of the real property if real property is to be delivered. With respect to other subject matter, the place of performance is at the location of the party who is to perform the obligation.
- (4) *Time for Performance.* In the event that the time period for performance is ambiguous, the obligor may perform at any time and the obligee may also demand the performance at any time, provided the necessary preparation time shall be given to the other party.

16. *Id.* art. 12. The Uniform Contract Law places the burden on a party providing "standardized clauses" to "remind the other party to pay attention to any clauses which release or limit its liabilities" and "shall explain the clauses if requested by the other party." *Id.* art. 39. The definition of "standardized clauses" is "clauses which have been drafted in advance by a party for repeated use." *Id.* The Uniform Contract Law also provides that attempts to release a party from its obligations or designed to deny the other party certain critical rights, are invalid. If a dispute arises concerning the understanding of a standardized clause, the Uniform Contract Law provides that the clause will be interpreted against the party that provided the contractual language. *Id.* arts. 41-42. In the event of a discrepancy between a standardized clause and a non-standardized clause, the non-standardized clause shall prevail. *See id.* arts. 41-42, and 53. This rule is recognized in the Insurance Law concerning the interpretation of standard insurance contracts. Insurance Law, art. 30. The Uniform Contract Law provides that a provision that seeks to exempt a party from liability as a result of intentional misconduct or gross negligence, which results in loss of property or bodily injury to the other party, is invalid. Uniform Contract Law, art. 53. The Consumer Protection Law has similar restrictions on manufacturers and sellers. Consumer Protection Law, art. 24.

17. *See* Uniform Contract Law, art. 61.

18. In the event that the official price is used, the price shall be the price at the time of delivery, if the official price is adjusted within the delivery term as provided for in the contract. In the event the delivery of goods is delayed, the original price shall be adopted if the price rises, and the new price shall be adopted if the price falls. In the event that the delivery is accepted or the payment is made after the expiration of the term, the new price shall be adopted if the price rises, and the original price shall be adopted if the price falls. *See id.* art. 63.

- (5) *Manner of Performance*. In the event the manner of performance is ambiguous, the performance shall be made in such a manner that facilitates the realization of the objective of the contract.
- (6) *Performance-Related Expenses*. In the event the parties fail to specify the obligations for performance-related expenses, such costs shall be borne by the party who performs the obligation.¹⁹

The Uniform Contract Law recognizes the principles of offer and acceptance in the formation of a contract.²⁰ An "offer" is defined as "the expression of an intent to enter into a contract with another party."²¹ An expression of intent is required to satisfy the following conditions:

- (1) the contents are specific and definite; and
- (2) when the offeree has indicated acceptance, the offeror shall be bound by the expression of intention.²²

The Uniform Contract Law provides that an offer is effective at the time it is received by the offeree.²³ An offer may be withdrawn provided that the recipient receives notice of withdrawal prior to or at the same time as the offer reaches the offeree.²⁴ In addition, an offer is revocable at any time prior to acceptance.²⁵ An offer is irrevocable if:

- (1) the offer stipulates a time limit for acceptance;
- (2) the irrevocability of the offer is expressly stated in the contract; or
- (3) the offeree has grounds to believe that the offer is irrevocable and has already performed under the contract.²⁶

The Uniform Contract Law provides that an offer is void under the following circumstances:

- (1) if rejected by the offeree and the offeror receives notice of the rejection;
- (2) the offeror withdraws or revokes the offer in accordance with the law;

19. *Id.* art. 62. This rule is consistent with article 88 of the Civil Law. The Uniform Contract Law also provides that in the event of a dispute in the construction and interpretation of a contract term, the meaning of the term shall be determined by reference to the phrases and sentences used in the contract, the relevant provisions of the contract, the course of dealing between the parties, and the principle of good faith. Where a contract is executed in two or more languages and it is provided that all versions are equally authentic, the words and sentences in each version shall be construed to have the same meaning. Where the words and sentences in one version are different from the other version, they shall be construed in light of the purpose of the contract. *See id.* art. 125.

20. *Id.* arts. 13 and 25.

21. *Id.* art. 14.

22. *See id.* art. 14. The law recognizes that sales catalogs, advertisements, requests for proposals, and prospectuses are invitations to make offers and not offers subject to acceptance. An advertisement for a commodity, however, is deemed to be an offer if the content meets the statutory requirements for an offer. *See id.* art. 15.

23. *Id.* art. 16. If a contract is concluded in the form of electronic data text and the addressee designates a specific system to receive the electronic data text, the time of arrival shall be deemed to be the time that such electronic data text enters the specific system. If no particular system is designated, the time of arrival shall be deemed to be the first time of entry of the electronic data text into any system of the addressee. *See id.*

24. *See id.* art. 17.

25. *See id.* art. 18.

26. *See id.* art. 19.

- (3) the time limit for acceptance has expired and the offeree has not accepted the offer;
or
- (4) the offeree materially alters the contents of the offer by tendering a counteroffer.²⁷

Under the Uniform Contract Law, an acceptance is the expression of intent by the offeree to assent to the offer.²⁸ The law provides that an acceptance is required to be "in the form of a notice," except in situations where acceptance is provided by a method that is consistent with the customs and practice of a particular transaction.²⁹ The Uniform Contract Law requires the acceptance of an offer to be tendered to the offeror within the time limit set forth in the offer. If the offer does not provide a time limit for acceptance, the acceptance must be tendered as follows:

- (1) if the offer is made verbally, the acceptance must be tendered immediately, unless otherwise agreed by the parties; or
- (2) if the offer is in written form, the acceptance must be tendered within a reasonable amount of time.³⁰

An acceptance may be withdrawn, provided the notice of withdrawal is received by the offeror prior to acceptance.³¹ If a party accepts an offer after the offer expires, the acceptance constitutes a new offer to the offeror.³² The acceptance is also required to be consistent with the contents of the offer. If the acceptance materially changes the contents of the offer, it constitutes a counteroffer. The Uniform Contract Law provides that a "material change" to an offer includes a modification of the terms concerning the subject matter, quantity, quality, price, time for performance, place and manner of performance, liability for breach, and method of dispute settlement.³³ If the acceptance contains a nonmaterial change to the contents of the offer, the acceptance is valid and a contract is formed, except in the following situations: (1) where the offeror timely objects to the change; or (2) where the language of the offer expressly indicates that the acceptance shall not make any changes to the content of the offer in any manner.³⁴

The contents of the acceptance shall form the contents of the contract, including any nonmaterial changes submitted by the offeree.³⁵ If the parties enter into a written instrument, the contractual relationship is created upon signing.³⁶ If the parties reach an agreement by the use of letters and electronic messages, a contract is formed when the confirmation instrument is signed.³⁷ The contract is formed at the place where the offer is accepted or, in situations involving the use of a written instrument, where the document is signed, unless otherwise agreed to by the parties.³⁸

27. *Id.* art. 20.

28. *Id.* art. 21.

29. *Id.* art. 22.

30. *See id.* art. 23.

31. *See id.* art. 27.

32. *See id.* art. 28.

33. *Id.* art. 30.

34. *See id.* art. 31.

35. *See id.*

36. *See id.* art. 32.

37. *See id.* art. 33.

38. *See id.* arts. 34–35.

B. VALIDITY OF CONTRACTS

If the laws or regulations specify that a contract must be approved or registered to be effective, the contract is effective upon approval and registration thereof.³⁹ If a contract is required by law to be in writing, the contract will not be deemed to be invalid if the parties perform the principal obligations under the contract.⁴⁰ A written contract that has been performed is not considered invalid by the failure of a party to sign the contract.⁴¹ The parties may agree upon a validity period for the contract. A contract including a time limit for its entry into force shall become effective upon the commencement of such term. A contract that includes a time limit for termination shall cease to be effective upon the expiration of such term.⁴²

A contract executed by a person with limited civil capacity (i.e., a minor) is only valid upon ratification by the legal guardian of the contracting party.⁴³ If an agent signs a contract without authority, the contract is invalid and the agent is liable to the principal for damages.⁴⁴ The Uniform Contract Law further provides that a contract is invalid in the following circumstances:

- (1) a party causes the other party to conclude the contract by fraudulent or coercive means or takes advantage of the other's difficulties causing it to conclude a contract against its true intention;
- (2) the contract is a malicious conspiracy or harms the interests of the state, a collective, or a third party;
- (3) the contract uses a legal form to conceal an illegal intent;
- (4) the contract harms the public interest; or
- (5) the contract violates the compulsory provisions of laws and administrative laws and regulations.⁴⁵

A party may apply to the People's Court or an arbitration tribunal, if applicable, to modify or cancel a contract procured under the circumstances noted above. A party to a contract may also apply to the court or tribunal to cancel or modify a contract in situations where the contract is concluded as a result of a material mistake or its terms are unconscionable.⁴⁶ A contract that is ruled to be invalid is cancelled *ab initio*, or from the beginning.⁴⁷ If a contract is ruled partially invalid, and invalidity does not affect the validity of the remaining

39. See *id.* arts. 36 and 44. The Uniform Contract Law recognizes the principal of conditions precedent, which provides that the parties may enter into a contract subject to certain conditions. *Id.* art. 45.

40. See *id.* art. 37. The various PRC laws require mandatory language for labor contracts, insurance contracts, real estate mortgage contracts, and other types of written obligations.

41. See *id.* art. 36.

42. See *id.* art. 44.

43. See *id.* art. 47.

44. See *id.* art. 48. Under the law, a party to a contract with an agent lacking authority may demand that the principal ratify its agent's acts or cancel the contract. After a period of thirty days, the principal has deemed to have rejected the contract signed by its agent without authorization. The disposition of property by an agent without authorization is invalid. See *id.* art. 51.

45. *Id.* art. 52.

46. See *id.* art. 54. A party must apply to the court for cancellation of a contract within one year from the date the party knows or should have known of such matter giving rise to the right of cancellation. See *id.* art. 55.

47. See *id.* art. 56.

provisions, the remaining parts shall continue to be valid. The invalidity, cancellation, amendment, or termination of a contract shall not affect the validity of any contract provisions concerning the method of settlement of disputes that exist independently.⁴⁸

If a contract is declared invalid or cancelled, any property obtained as a result of such contract shall be returned. If it is impossible or unnecessary to return such property, the property shall be valued and compensation paid based upon such valuation. The party in default shall compensate the other party for the losses incurred thereby. If both parties are in default, each party is responsible for their respective liability.⁴⁹

C. PERFORMANCE OF CONTRACTS

The Uniform Contract Law provides that each party to a contract shall perform its obligations as agreed upon in the contract.⁵⁰ If the parties agree that an obligor is required to render its performance to a third person, the obligor is liable to the obligee if it fails to perform.⁵¹ If the parties agree that a third person is required to perform the obligations of an obligor, the obligor is liable for breach of contract if the third person fails to perform the obligations.⁵² The law provides that a party cannot refuse to perform its obligations under a contract as a result of a change in its name, title, or legal representatives.⁵³

The party required to perform first may suspend its performance if, at any time, it receives reliable information demonstrating the following circumstances involving the other party:

- (1) the operational situation is seriously deteriorating;
- (2) transfer of its assets or withdrawal of its capital to evade obligations;
- (3) serious loss of its business reputation; or
- (4) other situations relating to the loss or possible loss of the obligor's ability to perform its obligations.⁵⁴

A party that desires to suspend performance based upon the above conditions is required to give the other party notice of suspension. The performance shall be resumed when the other party provides an "appropriate guarantee." After the performance is suspended, the party who suspends the performance may rescind the contract in the event the other party fails to resume its ability for performance or fails to provide an appropriate guarantee within a reasonable period.⁵⁵ An obligor may also suspend performance if an obligee has dissolved its operation, moved its location, or engaged in any activities making it difficult for the obligor to perform.⁵⁶

A party may reject another party's partial performance, except in situations where the nonperforming party substantially complies with the terms of the contract and does not

48. See *id.* arts. 56–57.

49. See *id.* art. 58. In situations where the parties collude in bad faith to the detriment of State interests, any property obtained as a result of the parties' acts may be returned to the State by the courts or arbitration tribunal. See *id.*

50. *Id.* art. 60.

51. See *id.* art. 64.

52. See *id.* art. 65.

53. See *id.* art. 76.

54. See *id.* art. 68.

55. See *id.* art. 69.

56. See *id.* art. 70.

cause damage to the interest of the other party. The increase of costs incurred as a result of partial performance shall be the obligation of the nonperforming party.⁵⁷ Similarly, a party may refuse the obligor's early performance, except in situations where such performance does not harm the obligee's interests. Any additional costs for early performance incurred by the obligee shall be borne by the obligor.⁵⁸

The obligor may place the subject matter in escrow under any of the following circumstances that renders it difficult for such party to perform:

- (1) the obligee refuses to take delivery of the subject matter without sufficient justification;
- (2) the location of the obligee is unknown; or
- (3) the obligee is deceased or disabled, and an heir or guardian has not been determined.

Where the subject matter is not fit for escrow, or the expenses of escrow are excessively high, the obligor may auction or liquidate the subject matter and place the proceeds into an escrow account.⁵⁹ Upon delivery of the subject matter or funds to escrow, the obligor must provide notice to the obligee or its heir or guardian in a timely manner, except where the obligee cannot be located.⁶⁰ The risk of damage to, or loss of, the items or funds in escrow shall be borne by the obligee, and all escrow fees and expenses are the responsibility of the obligee. Any interest or income derived from property or funds held in escrow shall vest in the obligee.⁶¹ The obligee may take delivery of the subject matter in escrow at any time. However, the escrow agent, in accordance with the instructions of the obligor, may refuse to allow the obligee to take delivery of the subject matter in escrow until the obligee fully performs its obligations. The rights of the obligee to take delivery of the subject matter in escrow shall lapse if not exercised by the obligee within five years from the time the subject matter is placed in escrow. Thereafter, the subject matter in escrow shall revert to the State after a deduction of reasonable escrow expenses.⁶²

D. AMENDMENT AND ASSIGNMENT OF CONTRACT

A contract may be amended by mutual consent of the parties. If approval and registration procedures for such amendments are required by law, an amendment is only effective upon approval and registration.⁶³ The parties to a contract may assign their rights to a contract, except in situations where by law or contract an assignment is improper.⁶⁴

E. TERMINATION OF CONTRACT

The Uniform Contract Law provides that a contract shall terminate under any of the following circumstances:

57. See *id.* art. 72.

58. See *id.* art. 71.

59. See *id.* art. 101; see also *id.* arts. 79 and 91.

60. See *id.* art. 102.

61. See *id.* art. 103.

62. See *id.* art. 104.

63. See *id.* art. 77. If an amendment is ambiguous, the contract shall be deemed to have not been amended. See *id.* art. 78.

64. See *id.* arts. 79–90.

- (1) the obligations have been fully performed as agreed in the contract;
- (2) the contract has been rescinded;
- (3) the obligations have been offset;
- (4) the obligor has made a lodgment of the subject matter of its performance in accordance with the law;
- (5) the obligee has released the obligations;⁶⁵
- (6) the obligations and liabilities are held by one person; or
- (7) there are other situations in which the contract shall be terminated as set forth in the law or agreed by the parties.⁶⁶

The parties may rescind a contract by mutual consent or in any of the following circumstances:

- (1) the purpose of the contract is rendered impossible to be achieved due to an event of force majeure;
- (2) prior to the expiration of the performance term, one of the parties expressly confirms, or indicates through its actions, that it will not perform its principal obligation;
- (3) one of the parties delays the performance of its main obligation and continues to fail to perform for a reasonable period after a performance demand;
- (4) one of the parties has delayed the performance of its obligations or engaged in other noncomplying actions, rendering it impossible to achieve the purpose of the contract; or
- (5) other circumstances of rescission as provided by law.⁶⁷

A party desiring to rescind a contract is required to provide notice to the other parties. Rescission is effective upon receipt of notice of cancellation. A party that objects to the notice may petition the People's Court or an arbitration tribunal, if applicable, for an order or award affirming the validity of the contract and to demand specific performance.⁶⁸ After a contract has been rescinded, the performance shall be discontinued for contracts that have not been performed. For contracts that have been performed, a party may request to be restored to its original state, or request that other remedial Government Procurement be adopted in accordance with the circumstances of performance or the nature of the contract.⁶⁹ The termination of a contract shall not affect the validity of its dispute resolution and liquidation clauses and shall not affect the right of a party to demand compensation for the damages.⁷⁰ A party to a contract is entitled to a set-off of its own obligations with the other party's obligations unless such set-off is not permitted under the contract or by law.⁷¹

65. Where a party to a contract releases the other party of its obligations, in part or in whole, the rights and obligations under the contract shall be discharged accordingly. *See id.* art. 105.

66. *Id.* arts. 91–106.

67. *See id.* art. 95. A right to rescind the contract expires after a reasonable period of time after notice to perform has been tendered to the nonperforming party or as stipulated in the contract. *See id.* art. 96.

68. *See id.* If government approval is required in order to rescind a contract, such approval is required for cancellation to be effective. *See id.*

69. *See id.* art. 97.

70. *See id.* art. 98.

71. *See id.* arts. 99–100.

F. REMEDIES FOR BREACH

If one party does not perform its contractual obligations or performs its contractual obligations in a manner not in accordance with the agreement, the other party has the right to demand the party in breach to perform such obligations, to take remedial Government Procurement, or to compensate him for damages incurred.⁷² Where one of the parties expressly states or indicates by its action that it will not perform its contractual obligations, the nonbreaching party may hold the other party liable for anticipatory breach of contract prior to the expiration of the time limit for performance.⁷³

When a party fails to perform a nonmonetary obligation, or fails to perform in accordance with the contract, the nonbreaching party may petition the People's Court or an arbitration tribunal for specific performance. The remedy of specific performance is not available in situations where performance cannot be rendered in law or in fact, the subject matter is unavailable on the market, the cost of specific performance is excessively high, or the obligee fails to demand performance within a reasonable time after breach.⁷⁴

The Uniform Contract Law provides that the amount of damages for breach of contract are equivalent to the nonbreaching party's loss resulting from the breach, including the benefit that may be derived from the performance of the contract, provided that the amount does not exceed the damages that are foreseen or should have been foreseen by the party in breach at the time of entering into the contract.⁷⁵ Where a business engages in fraudulent activities while providing goods or services to a consumer, it shall be liable for damages in accordance with the Consumer Protection Law.⁷⁶ Moreover, the Uniform Contract Law provides that an injured party may elect to pursue either contract or tort damages to the extent allowed under Chinese law.⁷⁷

If the quality is not as agreed upon, responsibility for the breach should be assumed in the manner agreed by the parties. If nothing has been agreed to with regard to the breach, or the agreement is not clear, the party that has been harmed can, according to the nature of the object and the amount of the damage, make a reasonable choice of whether to request repair, exchange, a remake, a return, a reduction in price, or a reduction in remuneration.⁷⁸ Additionally, if the quality is not as agreed upon and results in additional damage, compensation for the loss can be requested.

The parties to a contract may agree to liquidated damages or a method of calculating damages as a result of a breach.⁷⁹ The agreed cost of the breach is regarded as compensation for the damage caused, but if the amount agreed upon for the cost of the breach is lower than the damage that is produced, a party can request the People's Court or an arbitration tribunal to increase the damage award. If the agreed upon liquidated damages are consid-

72. See *id.* arts. 107 and 109.

73. See *id.* art. 108.

74. See *id.* art. 110.

75. See *id.* art. 113. This rule is consistent with the Economic Contract Law (article 33), the Foreign Economic Contract Law (article 18), and the Civil Law (article 112).

76. See Uniform Contract Law, art. 114. See Law of the People's Republic of China on the Protection of the Rights and Interests of Consumers, art. 35, [Business Regulation] China L. Foreign Bus. (CCH) ¶ 16-480 (Oct. 31, 1993) [hereinafter Consumer Protection Law].

77. Uniform Contract Law, art. 122.

78. See *id.* art. 111.

79. See *id.* arts. 114 and 116.

erably higher than the damage caused, a party can petition the People's Court or an arbitration tribunal to make an appropriate reduction.

In the event of a force majeure event, the obligations of the parties may be partially or wholly avoided. The Uniform Contract Law defines "force majeure" as "any objective circumstance that cannot be foreseen, avoided or overcome."⁸⁰ A party that cannot perform a contract due to force majeure is required to notify the other party promptly in order to reduce the possible loss to the other party, and, in addition, shall, within a reasonable time, provide evidence of such event of force majeure.⁸¹

A nonbreaching party is required to take appropriate Government Procurement to prevent the loss from increasing and thereby mitigate its losses. If a nonbreaching party does not take appropriate steps to prevent further loss or damage, it is barred by law from demanding damages for the loss for failure to mitigate.⁸² An injured party may recover all expenses incurred to mitigate its losses. If both parties are in breach, each is responsible for its respective obligations and damages will be apportioned accordingly.⁸³

G. CHOICE OF LAW/FORUM

The Uniform Contract Law provides that parties to a "foreign-related" contract may choose the applicable law, except when otherwise provided by law.⁸⁴ If the parties to a foreign-related contract fail to select the applicable law, the law of the country with the closest connection to the contract shall apply.⁸⁵ The Uniform Contract Law further provides that joint ventures, equity and contractual, and contracts for the exploration and development of natural and mineral resources performed within the territorial limits of China shall be governed by the laws and regulations of China.

The parties to a contract may agree to resolve their dispute through arbitration. Parties to a foreign-related contract may agree to designate an arbitration institution based either in or outside of China. If the parties fail to provide for arbitration in their contract, or if the arbitration clause is deemed to be invalid, either party may initiate litigation before the People's Court with jurisdiction over the parties and the dispute. The Uniform Contract Law provides that the parties to a contract must satisfy any court judgment or arbitral award and, if a party refuses to perform its obligations, the judgment creditor or prevailing party may petition the People's Court for enforcement.⁸⁶

80. *Id.* art. 117. The original draft of the Uniform Contract Law failed to include a definition of force majeure as an unforeseeable event.

81. *See id.* art. 118.

82. *See id.* arts. 112 and 119. This rule is consistent with the Foreign Economic Contract Law (article 22) and the Civil Law (article 115).

83. *See* Uniform Contract Law, art. 120.

84. *Id.* art. 126. The term "foreign-related" is undefined in the Uniform Contract Law. In the past, the People's Courts have had a difficult time in determining which contracts are "foreign-related" in upholding awards issued by the China International Economic and Trade Arbitration Commission (CIETAC), an arbitration institution that, at one time, was only allowed to assume jurisdiction over "foreign-related" disputes. CIETAC amended its rules in April 1998 to address this problem and to ensure that its awards are upheld by the courts. The lack of a definition in the Uniform Contract Law may lead to confusion and inconsistent application.

85. *See id.* art. 126.

86. *Id.* art. 128.

H. STATUTE OF LIMITATIONS

The Uniform Contract Law provides that in the event of a dispute arising from an international sale of goods contract, the limitations period for filing a claim with the People's Court or an arbitration institution is four years, commencing from the date on which the party knew or should have known its rights had been violated.⁸⁷ A contract involving the importation of technology has a limitation of four years.⁸⁸ Other than international sale of goods contracts and technology import contracts, the Uniform Contract Law provides the limitations periods for other types of contracts governed by other laws.

Under the Civil Law, and in general, the limitations period for filing a lawsuit or commencing arbitration is two years calculated from the date on which a party knew or should have known that there was a violation of its rights and interests.⁸⁹ The Civil Law provides for a one-year limitations period with respect to contractual matters involving the sale of a substandard product (i.e., breach of warranty), failure to pay rent under a lease agreement, or a loss of, or damage to, an item under a bailment contract.⁹⁰ The People's Court may, under special circumstances, extend the limitations period.⁹¹ The limitations period may be suspended if, within the final six months of the period of limitations, the injured party is unable to exercise its rights due to force majeure or other obstacles.⁹² Calculation of the limitations period shall continue after the reason for the suspension is eliminated. The limitations period shall be suspended if legal proceedings are commenced or if an interested party demands or agrees to fulfill its obligations under the contract.⁹³

I. SPECIALIZED CONTRACTS

In addition to general contractual principals, the Uniform Contract Law governs the following types of special contracts:

- (1) purchase and sales of goods contracts;
- (2) electricity, water, gas, and heat power supply and usage contracts;
- (3) gift contracts;⁹⁴
- (4) loan contracts;
- (5) lease contracts;
- (6) finance lease contracts;
- (7) hire of work contracts;

87. *Id.* art. 129. The four-year rule is consistent with the FEC Law and the International Sales of Goods Convention. FEC Law, art. 277. China is a signatory to the Convention on Contracts for the International Sale of Goods, 19 I.L.M. 671 (1980).

88. *See* Uniform Contract Law, art. 129. Under the former Technology Law, the limitations period was one year. However, the Technology Law did not apply to contracts involving foreign parties.

89. Civil Law, art. 135. A party that desires to perform its obligations after the limitations period is not barred from performance. *See id.* art. 138.

90. *Id.* art. 136. There is also a one-year limitations period for personal injury matters. The one-year limitations period on claims concerning the sale of substandard products is inconsistent with the two-year limitations period set forth in the Product Liability Law. *See* Chapter 9, Consumer Protection § A.4.

91. *See* Civil Law, art. 137.

92. *See id.* art. 139; *see also id.* art. 153 (defining force majeure).

93. *See id.* art. 140.

94. Uniform Contract Law, arts. 185–95.

- (8) project construction contracts;
- (9) transportation contracts;⁹⁵
- (10) technology contracts;
- (11) bailment contracts;⁹⁶
- (12) warehousing contracts;⁹⁷
- (13) agency contracts; and
- (14) brokerage contracts.

The Uniform Contract Law covers a broad range of contractual relations that are covered under other laws and, in particular, specialized laws and regulations including, but not limited to, the following:

Electricity Usage Contracts:	Electric Power Law
Loan Contracts:	Secured Interests Law, Commercial Bank Law
Project Construction Contracts:	Construction Law, Highway Law
Transportation Contracts:	Civil Aviation Law
Finance Lease Contracts:	Secured Interests Law
Lease Contracts:	Law on the Administration of Urban Real Estate
Insurance Contracts:	Insurance Law

Since these laws have not been formally superseded by the Uniform Contract Law, a party to a specialized contract is required to understand and appreciate the standards set forth in the Uniform Contract Law and other applicable laws and regulations. Indeed, the Uniform Contract Law provides that such special laws take priority.⁹⁸

II. Securities Law

In 1999, the Chinese government took steps to continue reforming and improving its regulation of the Chinese banking and securities sectors. The Chinese government committed itself to adhering to the Basle Core Principles on Banking Supervision and introduced reforms to fulfill that commitment. Despite that commitment, Chinese banks are concerned, for example, that there are no laws or regulations on realization of collateral. Commonly, Chinese banks auction collateral on the secondary market. To facilitate such disposal, Chinese banks feel they should be exempt from transfer charges and sales tax in connection with realization on collateral.

Also in 1999, China took steps to address the bad debt issue facing its banks. By some estimates, twenty percent of all outstanding bank loans in China are considered bad debt, either because they are undersecured, overdue, or both. The government created an asset management company (AMC), Chida, under the China Construction Bank to dispose of that bank's estimated 200 billion renminbi in bad loans. Future AMCs are to be established for the Bank of China, the Agricultural Bank of China, and the Industrial and Commercial Bank of China. AMCs will have broad powers to dispose of bad loans through asset liquidation, debt and equity swaps, auctions, and possibly direct management of indebted com-

95. *Id.* arts. 288–321. The law addresses the requirements for passenger and cargo transport contracts.

96. *Id.* arts. 365–80.

97. *Id.* arts. 381–95.

98. *Id.* arts. 123–24.

panies. In some cases, these AMC's may convert some state-owned enterprise debt into equity to be held by commercial banks.

Lastly, China's growing stock markets and associated regulatory changes in 1999 affected China's banks. In November 1999, the Shanghai Pudong Development Bank listed 320 million A-shares on the Shanghai Stock Exchange, the first time a joint-stock commercial bank issued stock after the July 1, 1999, implementation of the Securities Law. Also, in interpreting the Securities Law, the China Development Bank, which funds infrastructure projects, was held to be subject to the regulations prohibiting securities firms from operating within banks, despite its protests.

Regulation of China's securities markets changed significantly in 1999. China's Securities Law came into effect on July 1, 1999, and became the most significant regulatory event affecting China's securities markets during the last year. The Securities Law, with twelve chapters and 214 articles, unifies the 250 provisional sets of rules that formerly governed China's securities markets by, among other things, mandating standardized practices for issuing and trading shares and creating ethical rules and penalties for violations. A main function of the Securities Law is to state who may trade on the market and what kinds of funds may be invested. As with previous interim regulations, the Securities Law bans the inflow of foreign money into the A-share market and requires securities companies to separate their funds from those of their customers. The law also creates statutory prohibitions on, and penalties for, unfair trading, price manipulation, and similar practices. A flurry of regulatory drafting and interpretation accompanied the effective date of the Securities Law; the China Securities Regulatory Committee (CSRC) and other government entities continued drafting regulations affecting China's securities markets. These regulations include the following:

- (1) The National People's Congress (NPC) amended the Criminal Law to make illegal the following: (i) engaging in transactions after obtaining inside information (defined as unpublished information) regarding securities or futures dealings; (ii) spreading false information to disrupt the securities or futures markets; (iii) allowing employees of securities and futures firms to release false information, make fake transaction records, or manipulate the market price for personal gain; and (iv) establishing unauthorized commercial banks, stock and futures exchanges and brokerages, insurance companies, or other types of financial institutions. Violations of the foregoing may result in fines and/or imprisonment.
- (2) The State Council approved the CSRC Stock Listing Assessors Committee Regulation, drafted pursuant to the Securities Law. Under these regulations, stock listing assessors, who have final authority on whether issuers may be listed on China's stock markets, are required to be qualified and have good knowledge of China's macro-economic policies, laws concerning the securities markets, stock trading business, and other qualities. Stock Assessors Committee terms are to be two years, with no one serving more than three consecutive terms, except for certain permanent committee members; one-third of all committee members will be changed every two years. Non-CSRC officials are to make up seventy-eight percent of the Committee and decisions are to be made through a secret ballot requiring a two-thirds vote.
- (3) The NPC is reportedly considering a draft resolution to regulate the futures market and punish futures-related crimes. The proposed legislation will address issues such as the unauthorized establishment of futures exchanges, insider trading, price ma-

nipulation, deliberate release of false information, and unauthorized trading on overseas markets. In connection with this proposed futures legislation, the State Council has asked the NPC to amend the Criminal Law to punish certain futures-related crimes.

- (4) The CSRC announced that listed companies and State firms would be allowed to trade on the stock market, subject to a six-month mandatory holding period for each of their trades.
- (5) The Securities Law eases curbs on the acquisition of a company by individuals or institutions. As with prior regulation, investors must notify the government, the company, and the exchanges when they have purchased five percent of a company, with additional notifications at every five percent increase in ownership. Under the former regulations, investors had to notify the company, government, and exchange after subsequent increases of two percent. Also, the Securities Law ended the restriction that limited individual investors to owning a maximum of 0.5 percent of the total outstanding shares of a company.
- (6) Pursuant to the Securities Law, the CSRC abolished the quota system for approving new listings and replaced it with an expert review of the issuer's quality. This change has forced securities firms to create in-house groups to monitor underwriting activity.
- (7) According to an October agreement between the CSRC and the China Insurance Regulatory Commission, insurance firms may use premiums to purchase shares in certain investment funds.
- (8) New regulations for investment funds were announced pursuant to which the funds will be issued by existing fund management companies. The regulations are aimed at reducing the fund management companies' outlay and expanding the proportion of institutional investors in the stock markets.
- (9) According to the CSRC, Chinese securities companies will be given access to new money raising channels, including interbank lending and borrowing and bond repurchasing markets.
- (10) In April 1999, Zhou Zhengqing, chair of the CSRC, announced that the government plans to ease control on overseas listing for domestic companies. There will be no limit on the number or scale of companies entitled to overseas listing, provided they satisfy the stated requirements.
- (11) The NPC and its Standing Committee are reviewing a draft law, set to come into force during 2000, that delineates legislative powers and procedures as between the two bodies. Pursuant to the draft law, the NPC would take exclusive authority over finance and banking issues.
- (12) Companies with more than 400 million shares of capital stock will be allowed to place part of their stock with institutional investors and solicit strategic partners.
- (13) The Chinese Supreme People's Procuratorate (SPP) has created consultation committees, including one in the securities field, to discuss procuratorial issues, advise the SPP on issues, and offer advice.

Despite the implementation of the Securities Law and associated regulatory changes, there are indications that more work needs to be done. For example, the World Trade Organization's accession process has highlighted a need for a law governing investment funds, industrial investment funds, and venture capital; legislation in these areas is currently

being drafted by the NPC. Also, some feel a trust law is needed to regulate trust and investment corporations.

The Securities Law has also caused a shift in policies affecting China's securities markets. As part of the reform process, the Chinese government has adopted a policy allowing state-owned enterprises (SOE) to purchase stocks, thereby decreasing government ownership of SOE stock. The government is also considering a policy to convert certain SOEs to stock companies, allowing them to be listed on a stock exchange.

The implementation of the Securities Law has caused changes to the competitive structure of China's securities markets. The CSRC in February indicated that Chinese firms listed abroad should de-link their ties with major shareholders to ensure independent operations in order to become more attractive on international markets. In March, the CSRC announced it will give priority to initial public offerings of high-tech firms, in order to stimulate China's high-tech industry. Such companies will be allowed to go public regardless of their scale or ownership, assuming they pass CSRC scrutiny. In May, Guotai Securities Co., Ltd., of Shanghai and Jun'an Securities Co. Ltd. of Shenzhen announced their merger, creating the largest securities firm in China. In July, the CSRC approved the establishment of China's first two index-weighted mutual funds. The CSRC approved six securities firms to increase capital in order to qualify as a comprehensive securities firm and, in October, announced that Xiangcai Securities Co. Ltd., based in Hunan Province, became China's first comprehensive securities firm, allowing it to engage in brokering, underwriting, and operations on the secondary market.

In targeting specific sectors, there is some indication that public and private venture capital firms will be created to foster China's high-tech sector. For example, Beijing's Haidian District announced it would set aside thirty million yuan as starting venture capital for local high-tech firms. Further, as of November 8, 1999, more than twenty publicly traded Chinese companies, primarily high-tech companies, were preparing to issue B-shares in order to boost the B-share market. A new board listing high-tech firms is expected to come online in 2000.

The implementation of the Securities Law also empowers self-regulatory organizations to oversee China's securities sector. In December, the Securities Association of China (SAC) announced it had finished restructuring pursuant to the Securities Law. Before the implementation of the Securities Law, the SAC focused on member services. Now, the SAC has the status of a self-regulating organization, regulating its members, as well as educating and providing training and other information to its membership. Despite the restructuring of the SAC, some are calling for the creation of a more specialized foundation to protect the legal rights of and educate investors, mediate disputes, and investigate claims.

III. Merger and Division Rules for Foreign Enterprises

The Ministry of Foreign Trade and Economic Cooperation (MOFTEC) and the State Administration of Industry and Commerce (SAIC) have adopted their Rules on Merger and Division of Foreign Investment Enterprises (the Merger and Division Rules), effective November 1, 1999. The Merger and Division Rules constitute another important set of regulations promulgated by the Chinese government with respect to the merger and division of Foreign Investment Enterprises (FIE). This follows the promulgation by the State Administration of Taxation (SAT) of the Provisional Rules on Income Tax Treatment of Merger, Division, Equity Restructure, Asset Transfer and Reorganization of Foreign Investment Enterprises (the Merger and Division Tax Rules) on April 28, 1997, and the adop-

tion by the State Economic and Trade Committee on September 14, 1998, of the Provisional Rules on Utilizing Foreign Investment in Asset Reorganization of State-Owned Enterprises.

Chapter Seven of the Company Law of the People's Republic of China (Company Law) contains in total seven articles that set forth relevant rules on the merger and division of companies. However, these rules are relatively simplistic and fail to address issues such as those relating to application and approval procedures in connection with merger and division transactions by FIEs. Although there have been a number of approved cases granted by MOFTEC and its corresponding agencies at the local level (COFTECs⁹⁹) for mergers and divisions by FIEs, and although SAT promulgated the Merger and Division Tax Rules two years ago to facilitate these mergers and divisions, these approvals have not been based on a set of well-defined rules.

As a result, FIEs have faced uncertainties with respect to their merger and division transactions. Mergers and acquisitions are a major practice area of corporate lawyers (and other professional advisors) worldwide. Over the past twenty years of China's reform and opening to the outside world, foreign direct investment in China has amounted to over U.S.\$250 billion. Of those FIEs established with such a huge amount of foreign investment, it is inevitable that many of them will confront the need to effect a corporate merger or division. This has given rise to the necessity for MOFTEC and SAIC to promulgate these Merger and Division Rules.

The Merger and Division Rules are nevertheless a set of regulations adopted by ministry-level administrative authorities, which are inevitably subject to certain limits. For example, article 6 of the Merger and Division Rules provides: "The company surviving or newly established after a merger or division may continue to enjoy various kinds of treatment provided to FIEs, subject to verification by the approval authorities, customs authorities, tax authorities and other governmental agencies." The Merger and Division Rules basically resolve the issues relating to approvals by MOFTEC and COFTECs. However, these rules fail to provide detailed guidance as to approvals by the customs and tax authorities. As noted above, regulatory guidance on tax issues can be said to be provided under the Merger and Division Tax Rules. However, the applicable customs approval procedures remain unclear. In particular, there is no clear guidance on how to deal with duty-free imported goods in the custody of the Customs authorities of different jurisdictions in connection with a cross-jurisdictional merger (i.e., a merger between entities whose approval authorities differ). This remains one of the outstanding issues to be resolved even after implementation of the Merger and Division Rules.

A. FIE MERGER AND DIVISION

Under the Merger and Division Rules, mergers of FIEs¹⁰⁰ (referred to as "Companies" in the Merger and Division Rules and hereinafter) can be divided into two forms: "absorp-

99. This term usually refers to a provincial or municipal Commission on Foreign Trade and Economic Cooperations, Economic Committee (*Jing Wei*) or Planning and Economic Committee (*Ji Jing Wei*). The relevant authority in Shanghai, for example, is the Shanghai Municipal Foreign Investment Working Committee.

100. FIEs referred to in the Merger and Division Rules are defined as Sino-foreign equity joint enterprises, Sino-foreign cooperative joint ventures that have legal person status, wholly foreign-owned enterprises, or foreign investment joint stock companies. They are collectively referred to as "Companies" in the Merger and Division Rules.

tion mergers" and "new establishment mergers." This classification conforms to the provisions of the Company Law, but does not exactly conform to the terms used in the Merger and Division Tax Rules.¹⁰¹ An absorption merger refers to a merger transaction whereby one Company takes over another Company or a group of Companies; the acquiring Company continues to exist while the acquired Company is dissolved (after completion of the merger). A new establishment merger refers to a merger transaction whereby two or more Companies merge to establish a new Company and each party to the merger is dissolved (after completion of the merger). It should be noted, however, that whether the merger is an absorption merger or a new establishment merger the dissolved Companies need not be liquidated. All accounts receivable and debts of the dissolved Company will be assumed by the acquiring Company in the case of an absorption merger, or by the newly established Company in the case of a new establishment merger. The Merger and Division Rules require that the merger agreement entered into by the relevant Companies include a plan for the assumption of accounts receivable and debts of the relevant parties to the agreement.

With respect to the approvals from MOFTEC and COFTECs, the Merger and Division Rules set forth detailed rules concerning examination and approval procedures for Companies' mergers and, with respect to cross-jurisdictional mergers, specifically provide that, in the event the original approval authorities for the merging Companies are different, the COFTECs at the locality of the surviving Company should be the approval authority. At the same time, in order to give the COFTECs at the localities of the dissolving Companies a role in the entire transaction, the Merger and Division Rules require that a dissolving Company submit an application for dissolution as a result of merger to the COFTECs at the relevant locality before the merger application is formally submitted. The relevant COFTEC is required to reply to such application indicating its approval or denial within fifteen days thereafter, and a failure to reply will be deemed to be a grant of approval. In addition, the Merger and Division Rules provide for an appeal mechanism to deal with situations where the COFTECs at the locality of the dissolving Company refuse to approve the dissolution. Under this appeal mechanism, the dissolving Company may, after the denial of its dissolution application, submit the dissolution application to a higher-level foreign economic and trade authority with jurisdiction over the original approval authority and the approval authority for the merger. This higher-level foreign economic and trade authority is required to respond within thirty days after receipt of the application.¹⁰² In other words, if the COFTECs where the dissolving Company is located does not approve the dissolution, the dissolving Company may appeal to a higher-level COFTEC or MOFTEC to re-examine and overturn the denial of the dissolution made by the COFTEC. Setting up such an unprecedented appeal mechanism as a check against decisions made by the local approval authorities demonstrates the desire of MOFTEC to diminish local protectionist tendencies in order to facilitate cross-jurisdictional mergers.

The Merger and Division Rules also provide that if the merging Companies' aggregate total investments exceed the power of the original approval authority, an approval authority that has the requisite power must be the approval authority for the merger. For example, if there is at least one joint stock company among the merging Companies, MOFTEC

101. In the Merger and Division Tax Rules, an absorption merger is also referred to as "a continuation merger," and a new establishment merger is also referred to as "a dissolution merger."

102. The Merger and Division Rules fail to specify whether a failure to reply by the higher-level foreign economic and trade authority within such thirty-day period will be deemed to be a grant of approval.

should be the approval authority for the merger. These provisions, which conform to regulations previously promulgated by MOFTEC regarding the scope of approval power and foreign investment joint stock companies,¹⁰³ are aimed at incidents where some COFTECs have exceeded their scope of power and approved projects that have a total investment in excess of U.S.\$30 million.¹⁰⁴ Since a post-merger Company with a total investment in excess of U.S.\$30 million may be required to have its joint venture contract and articles of association reexamined by MOFTEC, it is likely that some Companies may abandon their merger plans, since the average investor generally believes that MOFTEC's standards in examining joint venture contracts and articles of association would be much more strict than those of a COFTEC. However, from another angle, since MOFTEC rarely takes Government Procurement that would cause losses to be established, FIEs with existing operations, obtaining MOFTEC's approval of a Company's joint venture contract and the articles of association via the merger procedure, would remedy any legal defects arising from approvals granted outside of the approval power limits or otherwise, thus strengthening the legal status of the Company.

The Merger and Division Rules provide that a Company cannot enter into a merger or division transaction until the investors in such Company have fully paid all required capital contributions, have furnished the required "cooperation conditions," and have caused the Company to commence actual production and operations in accordance with the joint venture contract and/or the articles of association. This rule is in line with the requirements that investors make timely capital contributions and put the Company into actual operation, which the Chinese government has repeatedly emphasized and stressed during the past two years. It seems, however, that this rule may be unduly restrictive, given that the investment period of many projects (particularly large projects) is often protracted. In cases where certain portions of the capital contribution remain unpaid because the capital payment is not yet due, no violation of the joint venture contract or the articles of association has occurred. Moreover, merger transactions may be a tool used to resolve the problem of a failure to pay up the required capital. It appears anomalous that Companies that may benefit commercially from mergers or divisions are barred from doing so merely because their investors have not fully made their capital contributions.

103. See Provisional Regulations on the Establishment of Foreign-Funded Joint Stock Companies Limited (Jan. 10, 1995), available at http://www.moftec.gov.cn/moftec/official/html/laws_and_regulations/investment18.html.

104. The issue of the power of a COFTEC is fairly complicated. Some local governments believe that the State Council previously granted them foreign investment approval power for projects with total investment in excess of U.S.\$30 million. (For instance, the Guangdong government believes that the scope of its approval power covers projects with total investment up to U.S.\$100 million). In fact, some take the position that the State Council or MOFTEC previously granted them the power to approve any nonmanufacturing projects (including infrastructure projects) without any monetary limit. The documents on which these views are based were published in the early 1980s. The officials of the State Council and MOFTEC have never explicitly confirmed whether these documents are still effective or whether these views are correct; therefore, the conservative view is that the power of COFTEC is limited to projects with total investment up to U.S.\$30 million. Recently, MOFTEC announced it would amend the foreign investment approval system so that foreign investment projects under the "Encouraged Category," which are not subject to "State General Balance" requirements, are subject only to approval of the provincial governments, with the approval to be filed with the State Planning Committee, the State Economic and Trade Committee, and MOFTEC. This new policy may, to a certain extent, resolve the question of the U.S.\$30 million approval limits, but leaves unresolved other issues such as the interpretation of the scope of projects not subject to "State General Balance" requirements.

The Merger and Division Rules further provide that, when the approval authority of a merger is MOFTEC and MOFTEC determines that the merger of the relevant Companies indicates a tendency toward an industrial monopoly or may otherwise result in particular goods or particular kinds of services becoming concentrated in a market monopoly that would constitute an interference with fair competition, MOFTEC is required, prior to granting any approval, to consult both the authority in charge of the relevant industry and the agency in charge of supervision and inspection of competition, as well as chambers of commerce, trade associations, and consumer organizations, conduct a hearing with respect to the contemplated post-merger Company, and initiate an investigation of the Company and the relevant markets. In any such case, the related approval period is extended from forty-five days to 180 days. By adopting this rule, MOFTEC has, for the first time, expressly set forth in formal regulations the "Joint Review and Approval" system that it has long followed in practice, and as a result of such adoption, MOFTEC has extended the approval period. In light of this rule, Companies that have a significant impact or market share in a certain industry must obtain the support of the government authorities in charge of their industry before the submission of the merger application to MOFTEC. Otherwise, without the requisite joint review and approval by the other authorities, MOFTEC may not grant its approval of the merger.

Pursuant to the Merger and Division Rules, the division of a Company can be conducted in one of two ways: through either a "continuation division" or a "dissolution division." A division refers to a situation where one Company divides into two or more Companies, with the original Company continuing its existence and one or more additional Companies being established as well. A dissolution division refers to a situation where one Company divides into two or more Companies; in this case, the original Company is dissolved and one or more new Companies are established. Although the Company Law does not contain similar classifications, these classifications are consistent with the Merger and Division Tax Rules. In accordance with the Merger and Division Tax Rules and the Merger and Division Rules, the dividing Company, in either case, does not need to go through a liquidation proceeding. The equity holders of the Company prior to the division may decide whether they will continue to be equity holders of all or part of the post-division Companies. All accounts receivable and debts of the pre-division Company should be assumed by the post-division Companies in accordance with the procedures set forth in the laws and regulations and in accordance with the relevant division agreement. This rule, which is consistent with article 185 of the Company Law, has significant practical implications.

Under the Merger and Division Rules, the sum of the registered capital of each of the post-division Companies should be equal to the registered capital of the pre-division Company, and the registered capital of the post-merger Company should be equal to the sum of the registered capital of each of the pre-merger Companies. This rule eliminates the possibility of capital increases or decreases by investors in connection with merger or division transactions. MOFTEC is apparently attempting to prohibit the withdrawal of capital under the guise of a merger or division by Companies that might be seeking to reduce the post-merger Company's or post-division Companies' liability toward third parties. However, given that merger and division transactions are generally part of a process of company reorganization, these strict requirements limit participants' flexibility to inject new capital into the organization in connection with any such reorganization. The requirement that no capital increase or decrease is allowed in the course of any merger or division is also contrary to provisions of the Company Law. These provisions apparently contemplate the

increase or decrease of capital in connection with a merger or division.¹⁰⁵ Given that the entire merger and division process is subject to approval of the government, these kinds of restrictions seem unnecessarily strict.

B. APPROVAL DOCUMENTS AND PUBLIC ANNOUNCEMENTS

The Merger and Division Rules give detailed guidance on the documentation that must be submitted by applicants to the approval authority. In addition to the standard required documents,¹⁰⁶ the documentation also includes the required list of creditors known to the relevant Companies and the employee settlement plan required to be included in the Merger or Division Agreement. Pursuant to the Company Law and the Merger and Division Rules, Companies must issue a notice to creditors or make a public announcement at the time of a merger or division. Creditors may, subject to applicable rules, request the relevant Companies to amend debt settlement or assumption plans, repay their debts, or provide guarantees for their debts. Companies failing to comply with such requests may not be able to obtain the required approval for a merger or division from the relevant approval authority. The requirement set forth in the Merger and Division Rules that the applicant provide a list of creditors to the approval authority apparently reflects the government's intent to understand the situations of the creditors of the Company and the Company's payment ability when the creditors request the Companies pay off their debts or provide guarantees. This provision of the Merger and Division Rules makes the approval contingent upon the overall practicability of the contemplated merger or division. In addition, the requirement set forth in the Merger and Division Rules that the Merger or Division Agreement include employee settlement Government Procurement is consistent with current policies of the Chinese government requiring all enterprises to provide for laid-off workers in a careful and appropriate manner. Without an appropriate employee settlement plan, Companies' merger or division transactions will be very difficult to accomplish.

The public announcement procedure set forth in the Merger and Division Rules is largely the same as that of the Company Law.¹⁰⁷ There is a special requirement that the Company or Companies concerned should not notify the creditors or make any public announcement until the Company or Companies have obtained a preliminary reply from the approval authority favorable to the contemplated merger or division. The Merger and Division Rules also prescribe that the newspaper in which the required public announcement is made should be a provincial-level newspaper with a nationwide circulation. In addition, the

105. The Company Law clearly spells out the requirements for matters relating to a company's capital increase or decrease under articles 186 and 187, set forth in the merger and divisions provisions under Chapter 7. Company Law, arts. 186 and 187.

106. The standard documents regularly required to be submitted include: the Application Form, board resolutions, a Merger or Division Agreement, the joint venture contract and/or the articles of association of the original Company (or Companies), the Approval Certificates and the Business Licenses of the relevant Companies, the balance sheets and the asset schedules of the relevant Companies, the joint venture contracts and/or the articles of association of the post-merger Company or the post-division Companies, and the list of directors of the Board of Directors of the post-merger Company or the post-division Companies.

107. Pursuant to the Company Law, a Company must notify its creditors within ten days after approving a merger or division resolution and must publish a public announcement three times in a newspaper within thirty days of such resolution.

Merger and Division Rules provide that after making two public announcements as legally required, the applicant must re-apply to the approval authority in order to obtain final approval for the contemplated merger or division. In other words, there are two approvals to be obtained, one before and one after the public announcement. This procedural requirement may be frustrating from an investor's point of view, but is not necessarily unwarranted. It appears, however, that the preliminary approval is the most important one and that the second approval seems to be more a procedural than a substantive requirement. In order to obtain the second approval, it is critical to obtain the creditor's written endorsement of the Company's debt settlement plan in a form satisfactory to the approval authority.

C. TAX CONSIDERATIONS

The Merger and Division Tax Rules provide a set of relatively lenient rules for the tax treatment of a merger or division. The general principle is that, after appropriate adjustment, the tax benefits originally enjoyed by each Company may be assumed by the post-merger or post-division successors. A detailed analysis of this tax treatment is beyond the scope of this memorandum. However, it is worth noting that the Merger and Division Rules provide that the post-merger or post-division Company's assets, debts, equity interests, and so forth, must be calculated based on their historical book value prior to the contemplated merger or division. This requirement prevents a Company from adjusting the book value of its assets to the re-assessed value (which typically will exceed the book value) and, therefore, from obtaining the benefit of an increased rate of depreciation and amortization. Also, in dealing with cumulative losses, the Merger and Division Tax Rules permit the outstanding cumulative operating loss of each Company incurred prior to the contemplated merger to be carried forward and recovered by the post-merger Company in subsequent years. As a result, if a Company with such losses merges with a profitable Company, the post-merger Company may use the losses to offset future profits of the post-merger Company and thereby legitimately reduce its future tax burden. In the course of a division the Companies may, through the provisions of the Division Agreement, allocate the prior accumulated losses to a post-division Company that has the potential to generate profits with a view to offsetting these profits. Thus, by properly structuring a merger or division, Companies may, to a certain extent, reduce their tax burdens.

D. CUSTOMS TREATMENT

The Merger and Division Rules provide that post-merger and post-division Companies may continue to enjoy favorable treatment afforded to FIEs upon verification by the relevant approval authority, Customs authorities, and tax authorities. As stated above, the Merger and Division Tax Rules have provided guidance for tax treatment. However, similar guidance tailored for customs treatment is lacking. Because of the failure to clearly address this area, dealing with issues relating to the import of duty-free equipment¹⁰⁸ is likely to

108. Pursuant to the Circular Concerning Adjustments on Duty Collection Policies for Equipment Import issued by the State Council dated December 29, 1997, commencing January 1, 1998, customs duty and import value-added taxes are waived for technology transfer-related foreign investment projects under the Encouraged Category and under Category B of the Restricted Category, except those goods listed in the Catalogue of Non-Duty-Free Goods for Foreign Investment Projects.

become a practical headache for Companies involved in any merger or division. In particular, there is no guidance for dealing with matters relating to duty-free equipment that has not yet been imported and such equipment's customs transfers. This makes it difficult to arrange customs-related affairs in a merger or division. We would hope that MOFTEC and the Customs authorities will consult each other as soon as possible in order to provide clear guidance in this regard.

In summary, the Merger and Division Rules constitute an important administrative rule-making exercise and are of great practical significance. Despite certain defects, the Merger and Division Rules represent a clear advance that will no doubt facilitate corporate reorganizations and merger and acquisition transactions involving FIEs within China, thus having a positive impact on Chinese policies on the use of foreign investment.